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Investing \$36 billion — of other people's money

Two Arizona state agencies control and invest more than \$36 billion in public funds, and to hear their leaders talk about it, they do a pretty good job of it. The Arizona State Retirement System (ASRS), under the direction of Paul Matson, invests approximately \$24 billion for the pension benefits of 420,000 state, county and municipal workers, plus school, university and community college staff. Some 70,000 retirees receive monthly checks. Meanwhile, State Treasurer Dean Martin's office is managing \$12.1 billion in assets. The full impact of the current troubled economy is yet to be known, but both agencies are upbeat about their investment results. In fact, Martin says his investment experts sensed the real estate bubble was about to burst before it became common knowledge, and began pulling out of the nation's largest mortgage lender. Both agencies operate under rather strict investment guidelines, yet have the flexibility to pick and choose where to place state funds.



The state pension fund, commonly known as ASRS, adheres to the following investment strategy: 45 percent in U.S. stocks; 26 percent in U.S. bonds; 18 percent in international stocks; 6 percent in real estate, and 5 percent in private equities.

The Treasurer's Office portfolio consists of 88 percent in bonds and fixed income — approximately \$10.7 billion, and 12 percent (\$1.4 billion) in equities. The treasurer's investment strategy differs based on the funds it receives: \$5.47 billion from state government offices; \$4.07 billion from local governments, and \$2.56 billion from the state's Permanent Endowment Fund, which was set up to invest earnings from state trust land sales.

Martin compares his office's strategies to those of ASRS. "We invest for the short term for state and local governments and in perpetuity for the Endowment Fund," he says. "ASRS is somewhat in the middle, investing for people's retirement with a time horizon of 20 to 30 years. We're much more limited in what we can invest in because of the short term nature of our strategy."

The sub-prime crash effect

Matson says the sub-prime mortgage crash and the accompanying downturn in residential real estate construction are having their effect on ASRS strategies. "We made some changes even before sub-prime became a big event," he says. "We diversified into private equities 10 months ago, we looked at our exposure throughout the portfolio, and we began taking a somewhat shorter duration in bonds, about a quarter of a year less than the average."

ASRS also shifted some money from government securities to federal agencies, including Fannie Mae and Freddie Mac. In addition, ASRS invested in "quality bonds in the non-financial sector — some of the biggest names in consumer products," Matson says.

ASRS investment rates of return for fiscal 2007 were as follows: 1 year, 17.8 percent; 3 years, 11.9 percent; 5 years, 11 percent; and 10 years, 8.4 percent. As a result, ASRS announced last month that "due to strong investment performance in recent years" the first decrease in the employees' contribution rate in 5 years will take effect next July 1.

At the same time, it was determined that there were no excess earnings in the most recent 10-year period, which means retirees did not receive an increase in their monthly benefit for fiscal 2008, which began last July 1. The earliest retirees can expect a pension increase is 2 years, which is somewhat sooner than originally thought, Matson says.

"We're a long-term investor," Matson says "To get returns of 17.8 percent, we need to keep economic exposures in various parts of the market, that's globally and U.S., and not just bonds. Our portfolio has to include stocks. We are accepting some of the short-term and mid-term volatility to achieve those returns. We have to commit capital to different sectors of the market so we can get those returns."

Types of risk

Risk is always on the mind of any investor, especially those with responsibility for public funds. Matson says: "Typically we look at risk two ways — relative risk analysis and absolute risk analysis. We look at various market indices, the S&P 500, the U.S. stock and bond markets, and the international market, and then we determine how much risk away from the series of benchmarks we're willing to take. That's relative risk analysis.

"With absolute risk analysis, we look at it from the return we expect to achieve over the long term, and we accept some deviation. When we build up the portfolio, we understand the relative and absolute risks and don't surpass either of those targets. It enables us to do the judgmental side and the quantitative side to make sure our judgments are logical."

Investments overseas increase

ASRS operates under several constraints imposed by statute. For example, no more than 30 percent of the funds can be in international investments; no more than 80 percent can be in equities, including U.S. and international; no more than 5 percent can be invested in any one company, and ASRS cannot own more than 5 percent of a company.

"The constraints don't tie us down too much," Matson says. "We're only at 20 percent in international and about 70 percent in equities."

The Legislature increased the international limit to 30 percent from 20 percent earlier this year. "We were getting close to 20 percent in international, and that's where we were making the most rate of returns," Matson says. "The dollar was falling. In 2007, international investments performed very well. Rather than pull back, we worked with the Legislature to increase the limit. We had asked for it for several years, and this year we were successful. The change went into effect in September."

After the 9/11 terrorist attacks, there was a move to ban investments in companies located in countries that foster terrorism, but Matson says the change in statute requires ASRS to provide the Legislature with an annual report listing the companies the agency invests in. The list includes companies that don't violate any U.S. laws but may have relationships with certain countries listed in the federal Export Control Act. "It doesn't say anything about divestiture," Matson says. "These laws come from Congress, and we make darn sure we follow them. We're hesitant to come up with our own foreign policy that is different from U.S. foreign policy."

State Treasurer Martin, who took office last January, says earnings for the fiscal year that ended June 30 totaled \$732 million, and the financial picture is looking brighter. For the first quarter of the current fiscal year (July-September), earnings exceeded \$143 million, an increase of 32.6 percent over the \$108 million in earnings recorded in the first quarter of fiscal 2007. "That blew my mind," he says.

One person, \$12 billion to manage

What did Martin do differently? He added two portfolio managers to the one who was on duty at the time.

"There was only one person managing 12 billion dollars," he says. "That's unheard of."

Martin made sure that new hires, including some who had worked at the Treasurer's Office previously, were brought up to speed. "We knew the housing bubble had burst," Martin says. "They looked at every asset and every security backing every asset so they knew what we owned. Before buying anything, we wanted to make sure the dogs were gone. We were not exposed to any risk, direct or indirect, to the sub-prime area." Martin emphasizes his philosophy, which appears prominently on the cover of the agency's annual report: "Safety before liquidity before yield."

Determining acceptable risk, Martin says, can change. "Certain things that may have been acceptable two years ago are no longer acceptable," he says. "It depends on where the markets are and where they're moving. We do have some hard, fast rules. We are only buying things that are A-rated or better. Our entire portfolio is all A-rated or better. If it falls into the B range, we wouldn't buy it, but we might hold it. That determination is made by the portfolio managers."

Any drop in a credit rating, even from AAA to AA, triggers an internal review to determine whether to keep it, Martin says. He cites as an example Countrywide Financial. In June 2006, the state had invested \$146 million in Countrywide, the largest home lender at the time.

Avoiding the Countrywide bomb

"That was too much exposure," Martin says. "There was no credit crunch and no housing bubble bursting then. Anytime there's a bubble, there's always going to be a bubble bursting. And if it bursts, the largest lender is going to be affected."

Martin credits Tim White, his chief investment officer who was handling investments in the previous administration, for beginning the process of pulling out of Countrywide. By January, when Martin took office, the state's investment in Countrywide had been cut in half, and a few months later it was down to \$10 million, Martin says.

"I'm not saying Countrywide is a bad investment," Martin says, "but we're dealing with taxpayer money. Safety is paramount."

The Treasurer's Office moved those funds into U.S. treasury bonds. "It's a very safe portfolio and it minimized our exposure to this whole mortgage crash. That's the reason why we did so well in the July-September first quarter. August is when the rest of the market woke up. We had already started the process before that, and now we're sitting on a portfolio that everybody else wishes they had."

One rule of investing public money, he says, is: "It's constant. Never sit still."

Watching the wall

Thanks to a sophisticated Bloomberg computer program, Martin's portfolio managers are keeping an eye on markets around the globe. Minute-by-minute fluctuations are projected on a wall, giving the managers a sense of what's happening and if a trend is developing.

Martin says 2008 looks good for returns, even with rate cuts by the Fed. With 88 percent of the portfolio in bonds and fixed income, and much of that in U.S. treasuries, Martin says, "That has an impact."

Still, Martin is confident going into 2008. "The economy, however, is a little bit different," he says. "We're looking for an overall slowdown in Arizona and the national economy in calendar 2008. I believe we're already in a recession. We saw this downturn back in March. We saw the numbers starting to go negative. "This is a different investing environment. Some people describe the credit crunch as the worst market since the Great Depression in some areas. We haven't had a big stock market crash in the equities. But in bond areas, it's very, very tight. The mortgage area is starting to get close to the size of the S&L situation. In the overall economy, we should be expecting very flat or mild recessionary times for a year or so."

After having recorded double-digit growth in the past few years, Martin says, "Zero growth will feel miserable. Housing is pulling us into this recession. Construction is a major part of our economy. It will have a bigger impact on Arizona than in other parts of the nation."

Matson of ASRS sees 2008 experiencing continued volatility in the stock and bond markets. "There will be some increase in the cost of capital, in risk premiums," he says, adding that lenders are charging more for risk. "And that's a good thing. People were investing money at high risk prior to 2007 for a moderate rate of return. They weren't getting enough return for the risk they were taking. Portfolios across the country were leveraged often at very, very high rates. People were buying houses they couldn't afford. Money was cheap and people were taking on more risk than what was prudent. That's changed."

"There are some negative implications, including the stock market volatility. But as we get through the negative implications, it is probably going to result in more prudent or wiser choices by investors going forward."

Treasurer wants random drug tests; Endowment funding shift

On the legislative front, Martin wants authority to conduct complete criminal background checks and do random drug tests on employees. He mentions an incident in the past in which an employee had been convicted of embezzlement in California, but was hired in Arizona. "We want broad authority to check on situations like that," he says.

The treasurer says he is looking at ways to improve investments for the Endowment Fund, which contains proceeds of state trust land sales. In addition, Martin wants to shift Endowment funding to a calendar year from a fiscal year.

"The reason is, now we estimate in June how well the performance is going to be in the following March," Martin says. "If we miss our estimates, the schools can't spend the money. If we go to a calendar year, we will know how much we made at the end of December and can give them a hard number. It doesn't make sense to announce in July what our estimate is. Teacher salaries are negotiated in April. Budgets are developed in April and May. When December ends, the schools will have hard numbers in March and be able to budget and set teacher salaries."

Matson has some legislative ideas, though not involving investment strategies. For new younger employees, who are likely to live longer, Matson recommends that they wait perhaps 2 1/2 years longer to receive a pension or pay a higher contribution rate.

Also for new employees, he would like to change the method for calculating benefits. Instead of using the highest 3 years of salary, Matson recommends taking a 5-year average.

People are taking advantage of the current system," Matson says. They might work 20-to-25 years at one salary level, then take a second job or work a lot of overtime to get a spike in their salary. What we're suggesting reduces the ability to spike salary."

Matson says he doesn't intend to lobby for either change, and regardless of what happens it won't require any changes in investment strategy.

With the \$36 billion that Martin and Matson have at their disposal to invest, someone recalled a quote by the late Illinois Sen. Everett Dirksen. When assessing the growing Defense Department budget, Dirksen, who died in 1969, remarked: "A billion here, a billion there and pretty soon you're talking about real money."

By Don Harris